A Program for Resolving the Crisis at Ardyn Bank

Prepared by: Ardo Hanson
For the USAID/Economic Policy Support Project; Ulaanbaatar, Mongolia
Development Alternatives, Inc.

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I. Introduction

1. The growing illiquidity of Ardyn Bank (AB) led Mongol Bank (MB) to place it under conservatorship on 18 September. The problems of AB, and the resulting loss in public confidence, have primarily grown out of its deep insolvency. A careful evaluation of AB's balance sheet indicated that, even after the replacement of inherited and directed loans, it has a negative net worth of 10 billion Tog as of end-June 1996. As AB is also operating at a loss, the size of the problem is becoming larger by the day, and has probably grown to a size of 12 billion Tog.

2. The experiences of many other countries show that such banking crises should be handled in a rapid and decisive manner. These actions should be designed to produce the following results:

--a rapid restoration of confidence in the banking system;

--limitation of the cost of resolving the crisis through use of effective asset recovery methods and the reduction of operating losses;

--an equitable and fiscally sustainable distribution of the losses between various groups in society (bank owners, depositors, taxpayers, etc.);

--the establishment of incentives which will reduce the size and likelihood of similar crises in the future; and

--the development of a competitive, market-oriented banking system.

3. This memorandum outlines a possible strategy for resolving the crisis at AB. Section II describes why the current policies are inconsistent with the outlined goals and why they cannot be continued. Section III describes the key features of an effective and equitable banking crisis resolution plan. Section IV outlines the Government's role in such an operation, stressing the need to avoid the extremes of total inaction and a complete rescue of depositors. Section V presents a detailed short-run action program for resolving the crisis at AB. Section VI outlines supportive actions to be taken by MB. Section VII describes the likely costs of the program, while Section VIII outlines its impact on the economy. Finally, Section IX describes the longer-term policies which will support the emergence of a healthy banking system in Mongolia.

II. Why the current policies cannot be continued

4. The policies pursued over the last several weeks cannot be continued for the following reasons:

a) The failure to explicitly freeze a part of deposits is leading to an inequitable sharing of burdens among creditors of AB. As long as AB remains open but lacks sufficient funds to meet the demands of all depositors, its payments will be governed by a "law of the jungle", where the best connected depositors recover all of their money, while less well-connected creditors and the state are left to bear an even larger future burden. Under such conditions, any liquidity assistance to AB would simply lead to a bailout of well-connected creditors by Mongolian taxpayers. This outcome is not in the spirit of the new Law on Banking Activities (LoBA), which places a particular emphasis on protecting household deposits.

b) These policies have left MB in the untenable position of bearing full responsibility for AB's actions without having effective control over the bank. The recent reappointment of AB senior management gives these persons actual control over the bank, including the choice of who to compensate first. Experiences of other transition economies show that the managers of a bank which has no future under their own leadership will have strong incentives to "strip assets" or otherwise abuse the bank. For example, the managers of Latvia's largest bank were able to transfer over $200 million out of the bank in the period before it was effectively taken over by the central bank.

c) The lack of clear rules has created confusion among depositors and the public about the future prospects of AB and about likely rates of deposit recovery, leading to large social tensions. It has also forced AB's conservators to define these rules themselves, placing them under severe pressure from various creditors urging them to take steps to support their interests.

d) These policies do not address the fundamental problem of insolvency, and will thus not stop the run on deposits. As long as the net worth of AB remains highly negative, it will have no realistic chance of growing out of its difficulties. Depositors who understand this will expect to lose part of any money which remains in the bank, creating incentives for them to quickly pull out as many funds as possible. These incentives can only be changed by decisive measures to bring the bank's liabilities to a level no larger than the true value of its assets.

e) These policies have led to little real restructuring and cost control, and thus to a continuation of the huge losses of AB (which have averaged around 0.5 billion Tog/month). The longer restructuring is delayed, the larger will be the losses which must be shared between AB's creditors and the state budget.

III. Key features of an effective and equitable action plan

5. The gaps in the policies pursued so far point to the main features of a more effective and equitable action plan. This should include decisive action in the following five areas:

a) An immediate partial freeze on deposits and other liabilities (to stop the uncontrolled outflow, ensure that all creditors are treated fairly, and prevent a run on the togrog);

b) Establishment of effective MB control over the activities of AB (to prevent abuses by current management);

c) Adoption of clear rules and guidelines to govern the work of conservators or receivers (to protect them from pressure from creditors, ensure equitable treatment of all creditors, and reduce uncertainty among the public);

d) A rapid recapitalization of AB (to restore confidence in the bank) in a way which shares the costs between bank owners, depositors and the state (placing the full burden on the state would strain the budget and create poor incentives for bankers and depositors, while placing this fully on depositors could create great political tensions and hamper the functioning of enterprises);

e) Commencement of rapid restructuring of AB by selling or closing unprofitable operations and releasing excess staff (to reduce the current losses of the bank).[1]

IV. The Government's role

6. The Mongolian Government will have a crucial role in resolving the crisis at AB, and should thus be an active participant in the design and implementation of a feasible crisis resolution plan.

7. Without government participation, the crisis would almost surely have to be resolved via outright liquidation of AB. Based on initial estimates, this would lead to a full loss of enterprise deposits and a 21-47 percent loss of household deposits. Such an outcome could lead to severe social tensions and be extremely disruptive to enterprises which had all of their money in AB.

8. At the same time, the Government's participation should be limited, and not result in its bearing the full cost of resolving the crisis. This would further strain an already strained state budget, i.e. place an excessive burden on Mongolian taxpayers. The large sums used for this purpose will have to be diverted from other needed programs or be raised through an increase in tax rates.

9. Such a solution would also send a dangerous signal to bank owners and depositors. If it led Mongolian depositors to expect similar bailouts in the future, they would pay little regard to the quality of the bank in which they deposit. This would play into the hands of weak or incompetent banks, which would be able to attract deposits in spite of their problems. If instead, Mongolian depositors begin to expect to bear part of the cost of a bank collapse, they will make greater efforts to place their funds in the soundest banks. This will reduce the size and likelihood of future crises.

10. The described factors point to an intermediate approach in which the Government would bear some but not all of the burden of restructuring AB. A concrete such program is described below.

V. A detailed action program for Ardyn Bank

11. The new LoBA which took effect on 1 October gives the Government and MB several instruments for implementing a decisive solution of the AB crisis. In taking such measures, the authorities should always use qualified legal counsel to avoid missteps which can be challenged in court.

12. This action program should begin on "Day C-2" (for second conservatorship) with imposition (based on Article 33 of the LoBA) of an effective conservatorship of AB. This means that MB should gain full control over AB. The two main steps for achieving this are:

a) Removal of former senior management of AB and their replacement by MB staff or other respected outsiders, and;

b) Imposition of a well-defined partial freeze on deposits and other liabilities (based on Article 36.2.2 of the LoBA) to prevent an uncontrolled withdrawal of funds which would damage the interests of some depositors.

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[1] AB currently has a staff of 1300 and a network of 61 branches and sub-branches.

13. On "Day C-2" the authorities should provide a frank public assessment of the financial state of AB, outline the future steps to be taken (including some information on the writing down of deposits after declaration of receivership), and clearly explain how these measures are meant to protect rather than harm the average depositor.[2] It should be stated that the final level of deposit writedowns will depend on the conservator's evaluations of AB's balance sheet.

14. The immediate deposit freeze should be more restrictive than the cut in deposits to be made after receivership (see below), and be consistent with the level of liquid resources available to AB. Depositors should be clearly told that any funds which they remove now will reduce their final claim on AB by an equal amount, in order to reduce the incentive for removing funds. A proper setting of deposit interest rates is another important way to discourage withdrawals. If "Day C-2" falls on a Friday or Saturday, the aim would be to make the unfrozen sums available upon the opening of business on Monday, i.e. to avoid an outright closure of AB.

15. On "Day C-2", MB should also announce an extraordinary meeting of AB shareholders to be held in about 7 days, where (among other things) owners will be given a chance to save the bank by providing additional capital. In preparation for this meeting, conservators should complete financial statements as of "Day C-2".[3] The valuation of AB's assets should be based on conservative (pessimistic) assumptions about likely recovery rates. This will determine the level of loss provisions which need to be made, and give a more accurate estimate of AB's true net worth.

16. At the meeting of AB shareholders, MB would:

-- explain that AB is deeply insolvent and in violation of MB capital adequacy requirements;

-- outline AB's other infringements of MB regulations (inadequate reserves, inaccurate reporting, etc.); and

-- formally give owners one week to raise additional share capital to increase AB's capital to levels adequate under current MB regulations (this will place the initial responsibility for rescuing the bank on its owners, and deflect any accusations that they had not been given the opportunity to do so).

17. If by "Day R" (for receivership), the owners have refused to or been unable to raise adequate capital, MB should formally register this fact and use Article 38 of the LoBA to appoint a receiver. At this point, it is crucial to write down AB's existing shares. This step must be a precondition for any Government financial support for restructuring AB, to prevent it from leading to a bailout of AB shareholders. This could be done in one of three ways (listed by declining preferability):

a) If the Government and state enterprises can control an AB shareholder meeting, a second meeting should be convened where owners would voluntarily write down their shares to, say, 1 Tog;

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[2] This should include a description of the consequences of doing nothing and of outright liquidation of AB.

[3] This includes the balance sheet, off-balance sheet items, income and expenditure statement since 1 January 1996, and financial notes describing valuation methods and other bases for adjustments.

b) The authorities can "strongly urge" shareholders to take this step by declaring that AB will otherwise be liquidated without any government compensation; or

c) The authorities can use legal means for forcibly writing down the value of these shares (possible avenues need to be further explored).

18. The receiver will begin his/her work by:

-- completing financial statements for AB as of "Day R", as a basis for setting the exact parameters of later measures;

-- where possible, set off deposit liabilities against outstanding loan payments owed by that depositor (Article 46.2.2 of the LoBA); and

-- begin identifying cases where payments since 18 September ("Day C-1" when the conservatorship was first announced) exceeded limits established by MB regulations (Article 40.3.1 of the LoBA).

19. Under the current circumstances in Mongolia, liquidation of AB through a sale of its assets (as described in Article 46.1.2 of the LoBA) could damage the interests of its creditors. This is because other banks, the most obvious buyers of AB's assets, also have limited free funds, and will thus only be able to offer very low prices for the sold assets. In addition, the small number of likely bidders for these assets would cut the degree of competition in asset auctions.

20. The average recovery rate is likely to be higher if a valuable "core" of AB can be kept functioning as a going concern while remaining loss-making operations are sold or closed down. As AB staff should have more information about the firms to which the bank has lent, the restructured AB should be better able to recover these loans than would a bank which has purchased these on the open market.

21. The rapid full restoration of AB's operations will only be possible if the value of its capital is quickly raised to a positive level through an increase in its assets and cut in its liabilities.

22. Based on AB's estimated negative net worth, and after having taken the steps outlined in Para. 18, the receivers should use Article 46.2.1 of the LoBA to reduce the value of AB's deposits and other liabilities in a way which ensures that recovered sums are no less than under liquidation. This will ensure that depositors bear some of the burden of restructuring AB. Specifically, the receivers should allow the following reduction in the value of liabilities (these figures must be refined after further evaluation of AB's loan portfolio):

a) The first 100,000 Tg of household deposits (including interest accumulated to "Day R"), less any sums which had been withdrawn after "Day C-1", should be fully compensated. This will lead to full protection of about 290,000 (88%) of AB's household deposits and vastly simplify the compensation process.

b) The remaining balance on household accounts should be reduced by the value of interest accumulated since [month, year], or by about [30] percent. As the ACTUAL interest accumulated in each account would be extremely difficult and time-consuming to calculate, this should be done using a single ESTIMATED interest rate for household deposits during this period. The value foregone interest should be converted into [1] share in AB of an equal face value, which will allow household depositors to receive additional amounts in the event that asset recovery proves more successful than expected (this is likely under conservative assumptions about asset recovery).

c) Enterprises and other non-government depositors in AB should be given the choice of one of the two following options:

--converting their frozen liability (including accumulated interest) for an unfrozen one of [40] percent of its current value; or

--converting this liability into an equal face value of freely tradable AB shares.

Owners of such liabilities should be given [2] weeks to take such a decision, with liabilities remaining fully frozen in the meantime. Since current estimates indicate that under reasonable assumptions about asset recovery, firms would lose their full deposit, the first option represents a favorable offer to enterprises. The second option should be viewed favorably by those enterprises which believe that AB is in fact healthy, in which case shares in a restructured AB would be worth even more than deposits. This will deflect claims that enterprise deposits are being cut too much, on the grounds that asset recovery will in fact be high.

d) Deposits belonging to the government sector should be fully converted into shares of AB. This will allow these institutions to receive some additional amounts in the event that asset recovery proves more successful than expected. This large cut will formalize the fact that the state is taking a major part of the cost of recapitalizing AB.

e) Liabilities to MB should be fully written down. This is consistent with Article 45 of the LoBA, which gives deposits a higher priority in payment of claims than "other creditors", which include MB loans to AB.

23. Since current estimates indicate that even these cuts in liabilities will leave AB with a negative net worth, the restoration of capital adequacy will require a further increase in capital through a bond issue. This burden can be shared by the Government and MB (the actual split should be decided in consultation with the IMF), with both receiving shares in AB with a face value equal to the value of bonds they have injected.

24. As a result of this restructuring of balance sheets, the receivership can be ended, AB's license restored, and the bank allowed operate normally (with full access to remaining deposits) under new management. The duration of receivership can be but a few days if all accounts can be recalculated and recapitalization bonds be placed in AB during this period.[4] MB should also urge AB to actively regulate its liquidity by setting interest rates at levels which encourage depositors to keep their money in the bank.

VI. Accompanying central bank actions

25. The described actions will impact on both the demand and effective supply of money, and thus call for adjustments and supportive actions by MB. The temporary decrease in public confidence in banks will lead to a fall in the demand for broad money (M2). This is why partial freezing of deposits (which cuts the effective money supply) is so important. If depositors were given full access to their funds at a time

[4] At this stage, the "bonds" need to be little more than a legal commitment by the Government and MB to provide the given amount of resources, including precise terms, interest rates, and repayment schedules.

when money demand has fallen, they would try to convert part of these into foreign exchange, putting pressure on the exchange rate.

26. In addition, the fall in confidence in banks will lead to a higher *desired* cash to deposit ratio (CDR). Part of this will be matched by an increase in the *actual* CDR due to a freezing of some deposits. As the behavior of Mongolian residents in this area is hard to predict, MB should be ready both to increase the supply of base money (including cash) in the event that the desired CDR increases more than the actual one, and to cut the supply of base money in the event that the desired ratio falls below the actual one.

27. Furthermore, MB should openly announce that it is ready to provide liquidity support to at least the major banks which, in spite of being generally healthy, could also be hit by a withdrawal of funds resulting from a loss of confidence. This announcement should reduce the probability of a wider banking panic. At the same time, these banks should actively protect their own liquidity by setting interest rates at levels which discourage depositors from withdrawing their funds.

28. This liquidity assistance should certainly extend to Agriculture, T&D and ITI Banks. If the authorities do not wish to take simultaneous action to close the deeply insolvent Insurance Bank (IB), they should not extend such liquidity support to IB. This would only open a channel through which well-connected depositors could remove their money, leaving a larger burden to be carried by those who are less fortunate.[5]

VII. Likely cost of the program

29. The total costs of the program depend on assumed rates of asset recovery, and their distribution between various groups depends on the rules chosen to govern the restructuring process. The Annex presents some preliminary estimates of these costs based on one set of assumptions.

VIII. Likely impact on the economy

30. The described resolution of the banking crisis will have several predictable short-term effects on the economy. First, it will lead to a slowdown of GDP growth relative to that assumed before the crisis broke. This should not be attributed to the adopted program, since the losses which lead to this contraction have already been incurred, and must be faced sooner or later. There is no way of avoiding these losses.

31. Second, the chosen method should cut inflation below levels predicted before the crisis. The freezing of deposits will mean that Mongolian residents have less immediate purchasing power, cutting the total level of demand, and thus putting downward pressure on inflation.

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[5] In any case, the authorities will soon have to take similar actions against IB. We suggest that this involve outright liquidation under the terms of the LoBA. The chances of successfully restructuring IB are small and the fiscal costs likely to be large. In addition, since IB has relatively few household deposits, current estimates show that individuals would eventually recover their full deposits even if the asset recovery rate was as low as 20%.

32. Third, the spread between deposit and lending interest rates is likely to rise. The credit squeeze resulting from a freezing of deposits will surely increase short-term lending rates. The movement in deposit rates depends on the relative change in the actual and desired CDR. If the actual rises above (falls below) the desired ratio, deposit rates will fall (rise).

33. This higher spread will have a negative effect on bank clients, but will increase the short-term profitability of banks. This will provide banks a window of opportunity to strengthen their capital base by building up reserves. It will also create incentives for banks to begin actively seeking deposits to lend on, setting in motion a market-driven process which will lead to a gradual reduction in these spreads over time.

34. Most importantly, the resolution of the AB crisis will require significant adjustments in the government budget. It will clearly lead to an increase in government expenditures to service the emitted government bonds. It will also cut government revenues through several channels:

--the resulting fall in GDP growth rates and inflation rates will cut the growth of nominal GDP, and thus of the tax base, relative to previously expected levels;

--the freezing or wiping out of deposits will make it more difficult for affected enterprises to pay their taxes; and

--the deposits lost by the government sector through resolution of the crisis will no longer be available.

This will require the national and local governments to present more conservative 1997 budgets based on lower planned revenues and expenditures. It could also require further cuts in 1996 expenditures, which could be formalized by the adoption of a negative supplementary budget for 1996.

35. The long-run impacts of the proposed crisis resolution plan grow out of the signals which it sends to households, enterprises and banks. The knowledge that depositing, borrowing and other decisions can lead to costs which will not be compensated by the Government will cause the makers of such decisions to be more careful. Enterprises and banks will be forced to take responsibility for ensuring their own survival, rather than simply hoping for state support. Only when they face such "tight budget constraints" will they begin to undertake serious restructuring, including improvement of product quality, marketing and service, and begin to actively compete with one another.

IX. Future steps for strengthening the banking system

36. If the reopened AB is to become profitable and secure, it will have to be further restructured. This should certainly be conducted under the ADB banking restructuring project. The fact that AB will be predominantly state-owned will initially facilitate such restructuring. One possible option would be an eventual splitting of the bank into a household-focussed Mongolian Savings Bank operating in the Selenge-UB-Tuv corridor, and an enterprise-focussed Ulaanbaatar Bank based only in UB. Remaining branches would be closed or sold to other banks.

37. The new state owners should ensure that AB does not pursue a rapid expansion strategy, but rather focuses on giving fewer but higher quality loans. This would not only increase its chances of becoming profitable, but also ensure that it does not again

become too large (thus raising the long-term level of competition in the banking sector).

38. To ensure the long-run emergence of a healthy banking system, these crisis resolution measures should be followed by additional reform measures. These include:

-- implementing the ADB-supported banking sector restructuring program, including developing a program for privatizing state-owned banks;

-- strict enforcement of minimum reserve requirements and other MB regulations, possibly phasing this in over several months to avoid an excessive shock (it is crucial for MB to develop a tough reputation in this sphere, with failure to meet these requirements leading to strong sanctions);

-- focussing the bulk of banking supervision efforts on Mongolia's major banks (as small banks do not create any systemic risks);

--adequate compensation of banks for processing pension payments and other services provided to the state (banks which are expected to survive in a commercial environment cannot be expected to provide subsidized services to the state);

--strengthening of Mongolia's bankruptcy system, including the adoption of a new bankruptcy law (this will improve overall financial discipline, spur restructuring, and lead to a fall in lending interest rates by providing banks with additional guarantees about repayment); and

--improving the system of providing collateral for loans, to allow banks to give loans with greater security, and thus improve the access of all Mongolians to credits at reasonable interest rates.

In all of the noted areas, Mongolia should seek extensive technical assistance from donors, as Eastern European and other countries have now had much easily transferable experience with such measures.

X. Timetable

39. One possible timetable for the actions described above would be as follows (the exact dates and intervals between dates would depend on the physical limits on certain steps, with compilation of financial statements and recomputation of deposits possibly being the major bottlenecks):

DATE	ACTION
Before C2	-Concretize general strategy -Begin concretizing details of strategy based on available financial statements, available budgetary resources, and feasible size of bond issue -Prepare logistics of new conservatorship
C2 (Fri.)	-Impose stronger conservatorship (replace AB senior management, announce tight partial freeze on deposits consistent with available liquid resources) -Explain outlines and intentions of subsequent steps to public -Announce extraordinary shareholder meeting and intention to allow AB owners to raise needed capital themselves

C2+1 (Sat.)	-Begin preparing financial statements as of Day C2 -Take steps needed to enact partial freeze on deposits, allowing limited operations by Day C2+3 -Establish need and rules for providing liquidity assistance to AB (provide only if this support will be repaid before other creditors, i.e. is not included in general state liabilities)
C2+3 (Mon.)	-Reopen AB allowing access to unfrozen part of deposits
C2+7 (Fri.)	-First extraordinary shareholder meeting
C2+14 (Fri.)	-Day R--second shareholder meeting -If owners have not come up with needed capital, declare receivership, appoint receiver, and take over ownership of AB -Explore possibilities for unfreezing some additional deposits if liquidity allows
C2+15 (Sat.)	-Begin rapid evaluation of Day R balance sheet to determine final parameters of deposit compensation/reduction -Begin finalizing size and form of bond issue
C2+16 (Sun.)	-Decide final parameters of deposit compensation/reduction -Begin recalculation of deposits
C2+19 (Wed.)	-End recalculation of deposits -Transfer state bonds to AB -Declare end to receivership -Reopen AB based on recalculated deposits -Provide adequate liquidity support at least to AB, T&D, ITI and Agriculture banks

ANNEX

Size and distribution of total costs of rehabilitating Ardyn Bank under various assumptions about asset recovery rates

1. In this Annex, we present the results of spreadsheet analysis of the size and distribution of the total costs of rehabilitating AB. The model allows a choice of a wide set of parameters concerning both the efficiency of asset recovery and the depositor compensation rules. We present the results for three asset recovery ratios under the following assumptions about depositor compensation:

--the first 100,000 Tog of all household deposits will be fully compensated;

--the remaining household deposits will be 70% compensated, with the remaining 30% being converted into AB shares of equal face value;

--enterprise deposits and other non-state liabilities will be 40% compensated, with remaining deposits liquidated;

--government sector deposits will be fully converted into shares of AB;

--MB liabilities will be fully erased; and

--if necessary, the authorities will issue bonds with a market value equal to par value to raise the unweighted capital/assets ratio to 14%.

2. The following table presents the costs of this operation, the implicit rate of compensation of large household deposits, the similar rate of compensation under liquidation (under two assumptions about the relative efficiency of liquidation vs. rehabilitation in ensuring asset recovery), the share of direct state ownership in the restructured bank, and the state's direct share of the total costs of restructuring.

3. The market value of any shares received as part of the recapitalization effort is entered with a negative sign. The price of a given share is calculated as ratio of the bank's net worth to the face value of share capital.

Asset recovery ratio under restructuring	77.5%	60%	40%
Cost to authorities			
Lost government deposits	6.40	6.40	6.40
Lost MB liabilities	5.00	5.00	5.00
Bonds issued	0	0	6.94
(Value of government shares)	-6.30	-2.38	-0.82
(Value of "recap shares")	0	0	-0.89
TOTAL	5.10	9.02	16.62
Cost to households			
Lost deposits	6.81	6.81	6.81
(Value of shares)	-6.71	-2.53	-0.88
TOTAL	0.10	4.28	5.94
Cost to firms/other creditors	5.22	5.22	5.22
TOTAL COST	10.42	18.52	27.78

Recovery ratio of large depositors (percent)	99.6	81.2	73.9
Recovery ratio under liquidation which is 75% as efficient as recap	100	79.5	53.0
Recovery ratio under liquidation which is 50% as efficient as recap	68.5	53.0	35.3
State ownership share in recapitalized bank	48.4	48.4	66.2
State share in total cost of recapitalization	48.9	48.7	59.8